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MARKET REPORT Q4 2016

MARKET COMMENTARY FROM PARMENION INVESTMENT MANAGEMENT

2016 will be remembered as the year the UK voted to abandon its 40 year relationship with Europe. A seismic shock for many, which was not predicted.

This was quickly followed by the election of Donald Trump, perhaps an even greater surprise given the rhetoric of his campaign. Both results have been described as a populist revolt against the ruling elites, a rejection of globalisation by those who have not benefitted. Will 2016 be known as a historic year? Perhaps that is a question for future historians, but from an investment point of view the political changes could potentially have important economic implications.

But first, who were the winners and losers in 2016? Emerging Markets and Commodities both recovered strongly after spending four years in the doldrums, rising by 35% in sterling terms. Stock market returns bettered bonds (global bonds were up a mere 3%), with the US rising by 35% (sterling terms) and both Japan (up 25%) and Europe (up 19%) posting decent returns. The UK lagged with a still respectable rise of 16%. It should be remembered that the overseas market returns were flattered by the 18% fall in Sterling (vs. US $) since the Brexit referendum.

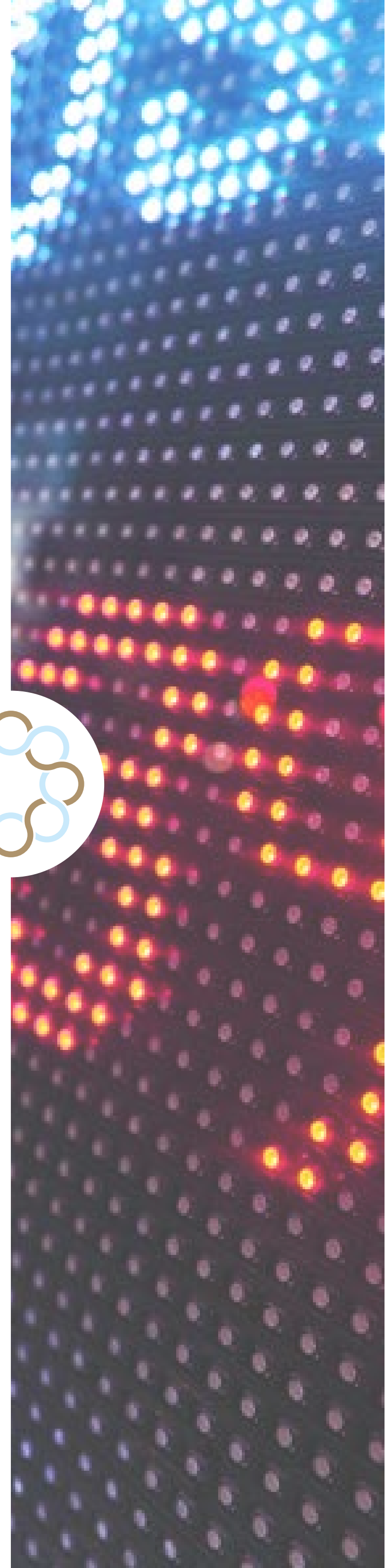
A significant outcome of the Brexit and Trump votes has been a change from an austerity agenda to one of fiscal expansion. For many it appears that central banks have done as much as they can with record low interest rates and now it is the turn of governments to take up the baton with the fiscal tools available. Trump has promised a growth agenda that includes tax cuts, new trade agreements, large spending on infrastructure and perhaps relaxation of regulation on the activities of banks. For the UK, a change of Prime Minister and a new Chancellor has resulted in the abandonment of the targeted budget surplus by 2020, giving the government more fiscal freedom to assist with managing the increased economic uncertainty precipitated by the Brexit vote.

Another feature of the above votes has been the expectation of a rise in inflation. In the US the Federal Reserve did raise rates in December to 0.75% as a sign of confidence in the economy. With a strong pro-growth rhetoric from the new President, investors should perhaps expect more rises in 2017. The rises are in contrast to the UK where rates were lowered to 0.25% post the Brexit vote. However, with the fall in sterling, which raises the price of imports, inflation will likely rise to nearer 3% next year. Despite the forecasts of economic gloom by the IMF and OECD for the UK economy following Brexit, to date this has not been the case. Consumer confidence and spending have held up well, employment continues to increase, as do wages.

Another source of inflation may be a sustained rise in the oil price. The Russian led agreement between OPEC and non OPEC countries helped to limit production in the first half of 2017, which led to falling oil inventories, allowing the fundamentals of demand and supply to reassert themselves. And if Trump does match his rhetoric and spend on infrastructure, demand for commodities as a whole may rise and with that prices. For economies the talk will be more of growth rather than recession, and inflation rather than deflation.

The 2017 outlook is uncertain, there are just too many unknowns to make tentative predictions. Will the year be driven by politics rather than the economics? Certainly the elections in France and Germany will loom large for investors, their outcomes perhaps a reflection of their populations' continued appetite for the EU. As for the UK, the government have stated that Article 50, by which we formally start the timetable of leaving the EU, will be invoked by the end of March. The flavour of Brexit, whether hard or soft may become clearer as the year progresses. And then who knows if the experience of Presidential office will temper Trump? Next year may be a challenge, but it will not be dull.

First published on 13th January 2017 by Simon Brett of Parmenion Investment Management.



A REALITY CHECK

The greatest challenge facing advanced economies during the next phase of the recovery cycle is to establish stronger productivity growth. While headline activity numbers for many economies may have looked dull at best, the accompanying gains in productivity have been even more disappointing.

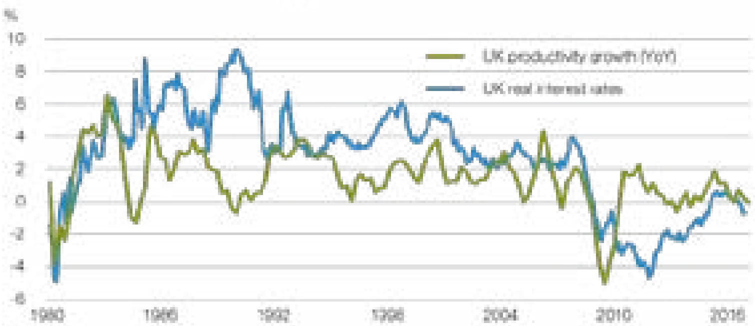
One positive consequence of the weak trends in productivity has been that the rate of job creation associated with even fairly modest GDP growth has been much greater than would normally be expected. As a result, labour markets in countries such as the US, Germany and the UK are now looking very tight. Another, but less helpful, consequence of poor improvements in productivity is that inflationadjusted per capita income growth has been weak. This helps explain why there seems to be increasing dissatisfaction amongst employed people; although economies are growing, the average employee does not feel an improvement in living standards.

For central banks, the current situation presents a conundrum: why are companies not undertaking much higher levels of productivity-enhancing capital investment at a time when short and long-term borrowing costs are so low? While there are many possible explanations, one in particular questions the efficacy of unconventional monetary policy - the combination of quantitative easing (QE) with exceptionally low or even negative interest rates. In more normal times, we might expect to see interest rates and bond yields of around 4%. Companies wishing to raise capital or maintain positive share-price momentum would have to offer a return in excess of the 'risk-free' rates. Returns to equity investors come from three sources:dividend yield, growth in dividends and capital growth. However, we are not in normal times. Compared to the current exceptionally low returns from 'risk-free' cash and bonds, the running yield on equities is sufficient, in itself, to make equities the more attractive asset class. This reduces the incentive on companies to undertake capital investment projects that, inevitably, involve a degree of risk. In effect, therefore, very low interest rates may be a cause of corporate lethargy.Excessively easing monetary conditions may have been counterproductive in other ways too. Central banks, however, have recently remained extremely risk averse. This has been particularly true in the US, where the Federal Reserve (the Fed), having projected a number of interest rate rises in 2016, did not move until December – the first anniversary of the initial very tentative move towards policy normalisation.

While the Fed has found adequate reasons to procrastinate, the European Central Bank has judged economic conditions to be sufficiently weak to justify continuing its programme of QE, reinforced by the adoption of negative interest rates. The same has been true in Japan, where the authorities have persisted with the use of cyclical policy tools to address what are deep structural problems in the economy. Meanwhile, in the UK, in the face of an unexpected result in this summer's referendum, the Bank of England cut rates to 0.25% and resurrected its QE programme. QE has long been expected to be inflationary – some will argue that it has already been, through rising asset prices, but this is not conventionally regarded as inflationary. During 2016, there have been hints that inflation might be about to become more widespread. While it had been the case that global overcapacity in elements of the supply chain had been putting downwards pressure on prices, this is now less obvious. Energy and other commodity prices have risen during 2016, and manufacturing based economies (particularly those in Asia) have begun to adapt to weaker demand trends in advanced economies. At the same time, there is evidence that tighter labour markets are beginning to be reflected in higher employment costs, particularly in the US.

Putting these various arguments together suggests what might seem a rather weird transmission mechanism between unconventional monetary policies and the price level, the connection being made through the low productivity growth that is currently evident.

UK real interest rates vs. productivity growth

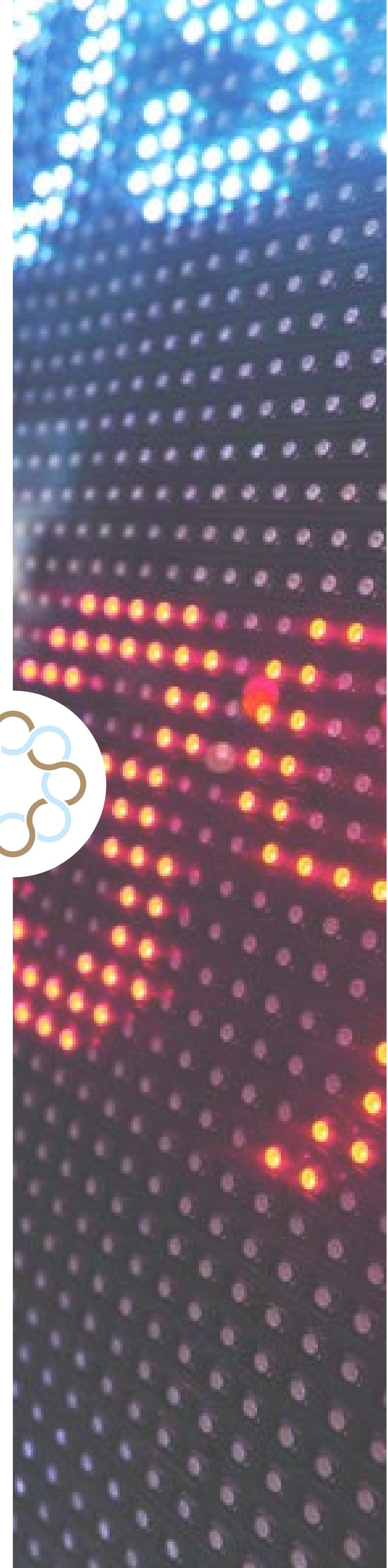


Source: Datastream.

If this is true, then rather than something to be feared, the gradual normalisation of monetary policy is something that should be welcomed, as it should be accompanied by improved gains in productivity, and ease the strains evident in certain labour markets. While second-guessing central banks has been difficult in recent years, it does now seem that the Fed will begin to step up the pace of tightening in 2017, although it seems unlikely other central banks will follow their lead. The biggest issue for central banks in 2017 is likely to be inflation, and whether incipient cost and price rises become more obvious. Only then will markets learn the inflation tolerance of central banks.

In terms of growth, in the face of disappointing outturns in many economies in 2016, economists have been cutting forecasts for 2017. This has been particularly true for the UK, where it is estimated that the Brexit growth penalty would be around 1% in each of the next two years. More generally, we believe that forecasts for growth in advanced economies in 2017 may now have been reduced too far. We would expect the US to top the G7 growth league, building on the momentum gained through the second half of 2016. The additional angle that will need to be watched however, is the impact the incoming president's policies may have on both domestic and world growth.

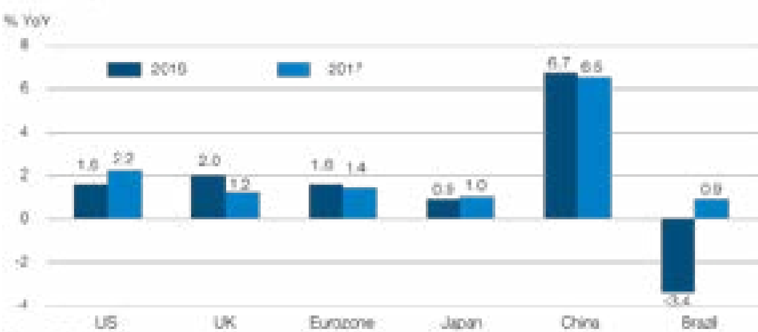
Ironically, despite dire prognostications in the immediate aftermath of the referendum, in 2016, the UK is likely to be the fastest growing country in the G7. While a dip in growth does seem probable in 2017, we believe the downside risks to



activity are currently overstated. For the eurozone, the north/ south contrast is likely to remain evident in an overall growth rate that is set to remain sub-optimal. Japan also seems likely to remain mired by the deflationary forces that have depressed growth over the past 20 years.

Overall, this implies 2017 growth at a similar pace to 2016 for advanced economies. For emerging economies, this makes for a similar demand backdrop in the year ahead, although these economies have been adapting to the changed pace of western growth, and are now looking more resilient. While the banking system in China remains stressed, growth seems to have stabilised (albeit at a lower rate than the official target), and prospects for other countries in the area are also improving. One interesting turnaround that may be seen in 2017 is in Brazil, where, finally, the economy is expected to emerge from recession.

Economic growth forecasts



Source: Bloomberg.

Investment markets in 2017 may also see a continuation of trends from 2016. Equity markets started 2016 in a volatile fashion based off concerns about global disinflation and near-term political events. Yet perversely, when the feared 'negative' outcomes unfolded (the Brexit vote, Trump's victory and failed Italian referendum) markets generally dismissed the forecasted negatives in an increasingly rapid fashion. The key to next year's overall returns, however, may well be investors' perception of inflationary risks and the behaviour of bond markets.

US and UK inflation

Source: Datastream.

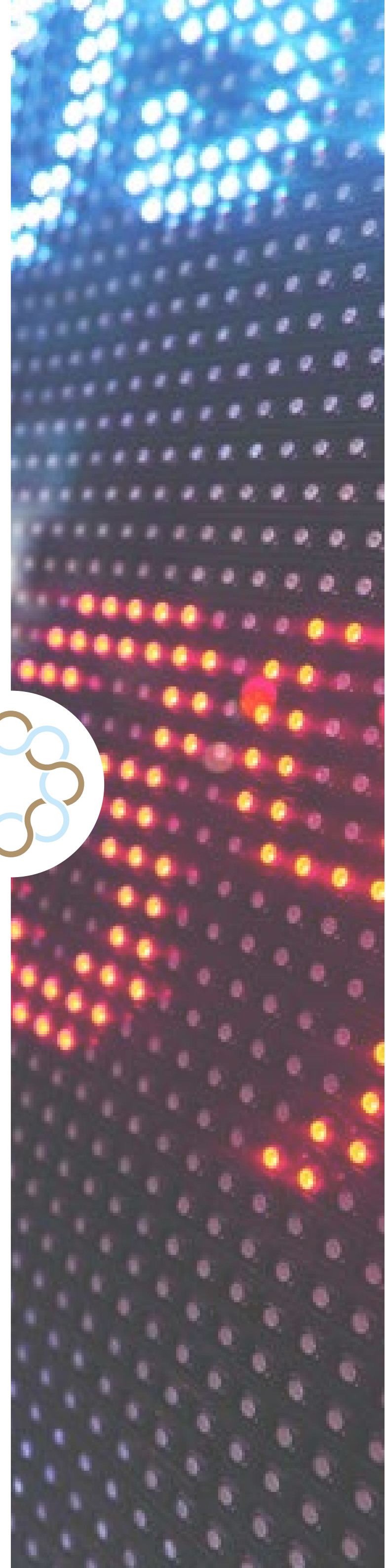
Investor focus has switched last year from fears of disinflation/ deflation to worries of rising and potentially persistent inflation. The perceived wisdom for a large part of the year was for continuing disinflationary forces globally, so much so that 10 year gilt yields fell to 0.50% post-Brexit. However, as economies showed resilience, labour markets continued to tighten in several key advanced economies, oil rebounded and fears of disinflation gave way to expectations of the return of inflation. This repositioning resulted in a sharp fall in bond prices, particularly in the UK and US from late summer onwards. Despite UK 10-year yields almost tripling from their lows, they still ended 2016 below their starting point, while yields in the US ended the year higher.

As mentioned, one of the key drivers of investment markets in 2017 will be the reaction of the bond markets in the face of continuing strength in economies, the US in particular, and the impact it has on interest rates. Any sharp increase in bond yields will not only lead to losses in fixed income holdings but will also threaten the valuation support to other asset classes. The style rotation we have seen in equity markets, from growth to value, is also likely to continue this year as investors focus more on cyclical exposure and shift away from defensive bond proxies.

Parallel to the bond market reaction is the strength, or otherwise, of the US dollar. While a number of factors point to a stronger dollar (for example the strengthening economy and interest rate differential), this is a consensus view and thus may largely be positioned for. Despite this, 2017 may well be a continuation of 2016 where currency returns strongly influence investors' total returns, driven by changing regional expectations of economic growth, inflation, interest rate differences and of course politics.

With growth rates better but still relatively dull, overall investor returns are not likely to be as exciting as 2016. If we do get headwinds from higher bond yields, this may mean a choppier year ahead, however, as longer-term investors, we should view volatility as potential opportunity.

First published on 9th Janiary 2017 by Richard Jeffrey, Chief Economist, and Caspar Rock, Chief Investment Officer, at Cazenove Capital Management.



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